RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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Dec. 9, 1992 **LETTER 1110**

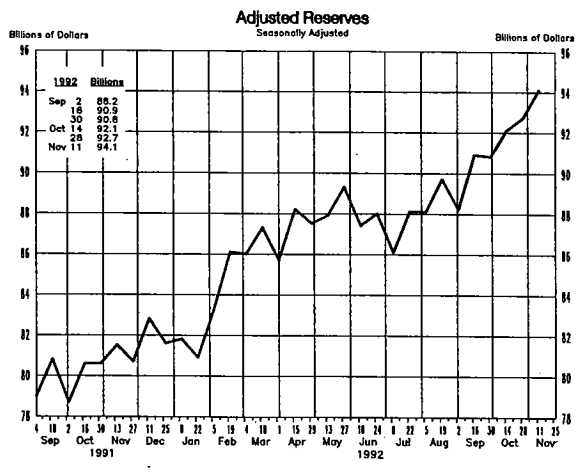
Nov. 27 DJIA 3282.20; PTI 3620; A-D Ratio -8.90
Dec. 4 DJIA 3288.68; PTI 3631; A-D Ratio -8.60
Dow Yield: 3.13%; Dow Price/Earnings: 44.0
Dow 200-day MA: 3289; Dow 30-day MA: 3235
Dow Times Book Value: 2.52; PTI 89-day MA: 3568
Percentage of Undervalued Blue-chips: 10%
Low Risk Buy Index: +113

THE PICTURE: It's really a fascinating situation. We see the economic statistics turning positive (George, how could they do this to you!), and we hear President-elect Clinton saying that maybe he won't have to jump-start the economy after all.

But here's the interesting part -- prior to almost every recession, the stock market has headed down (into a bear market or severe reaction). During the decline the market discounts the worst that can be seen ahead, until finally the market becomes acutely oversold. At or near the bottom, common stocks become very attractive, often irresistible on a value basis.

But that is not what happened during 1991-92. During this period, as the economy sunk into recession, stocks never really reacted. Instead they moved up into an extended high-level trading range. Furthermore, by almost any measurement, stocks became over-valued, and in the case of the blue-chips, flagrantly overvalued (see later section of this Letter on values).

In its battle against recession and deflation, the Fed, during the 1990-92 period, dropped both the Fed Funds and the Discount Rate to absurdly low levels. This process collapsed short-term interest rates and pressured savers out of CDs and into the stock and bond markets. At the same time, the Fed pumped up the money supply at an astounding rate, as seen on this latest chart from the St. Louis Federal Reserve. Adjusted Reserves are bank reserves which will later be translated into available money. From September 16 to November 11 (the latest reporting period), Adjusted Reserves (at a compounded annual rate) rose at the outlandish rate of 31%. The Fed evidently wants to hand president-elect Clinton an economy that's awash with funds.



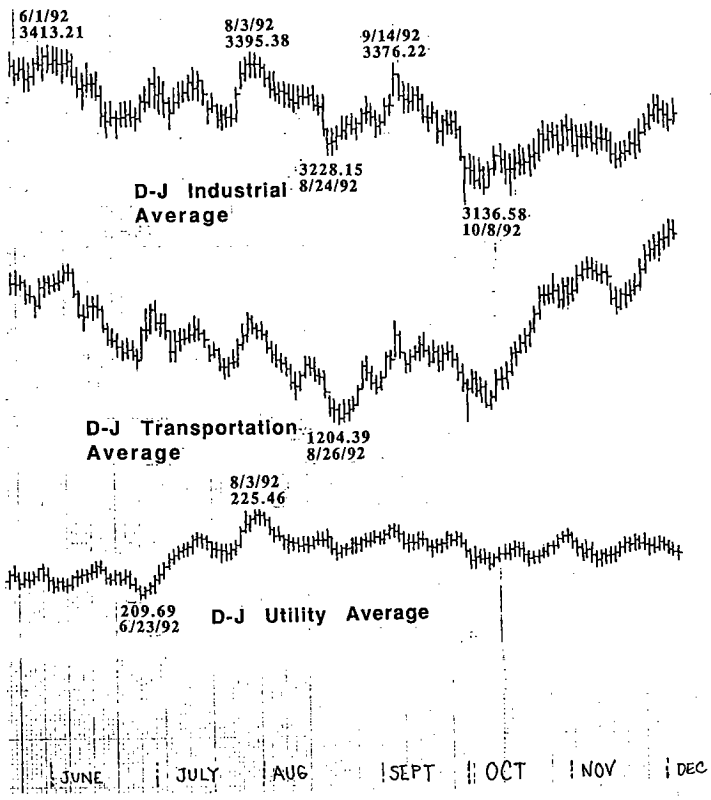
So here's the current picture in a nutshell -- the recession is receding, and the current "economic upturn" has arrived with (1) the stock market already at dangerously high levels of overvaluation and (2) with the NYSE Composite, the S&P 500 and the Wilshire already at record highs.

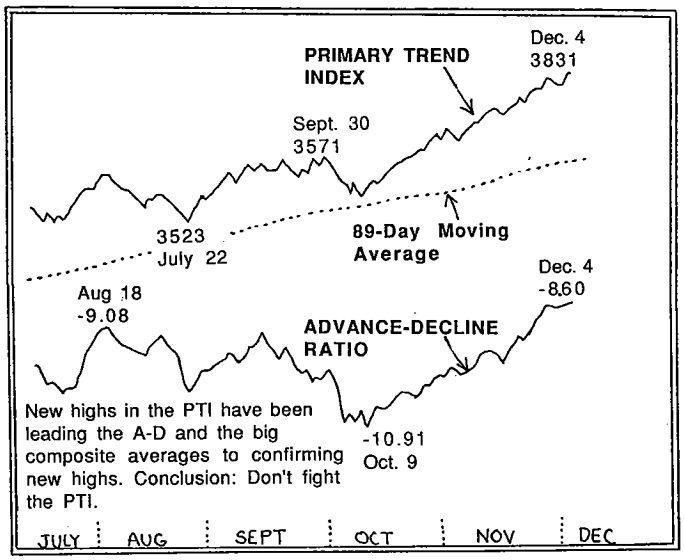
In the meantime, the money markets are in the process of protecting themselves -- which means that money instruments have been declining, and interest rates have been edging higher.

Rates normally rise at the onset of an economic recovery. Because stocks are undervalued during the early stages of a normal recovery, stocks can advance despite rising interest rates. But today, with the Dow yielding around 3% and with the S&P 500 yielding roughly the same, rising rates present much more of a problem. Since stock values are always measured against bond values, every uptick in interest rates renders stocks increasingly overvalued while at the same time pushing them further into the danger zone.

TECHNICALS: Technically, we have a situation where, for the third time this year, the S&P 500 and the NYSE Composite have risen to new record highs --unconfirmed by the Dow. Furthermore, we have the Dow Transports rising above their preceding peak and here again the Dow has refused to confirm. On the face of it, these non-confirmations should be considered danger signals. Remember, no 30 stocks are more analyzed, scrutinized, measured and judged than the 30 Dow Industrials. When these 30 giant stocks refuse to better their previous highs, knowledgeable investors take notice.

From a strength standpoint, the advance that started from the October 9 lows is really a strange one. Since October 9 we have not had a single day in which there were less than 600 declines. Furthermore, for a strong day in which advances are two to one over declines, you have to go all the way back to September 14. In





other words, a lot of selling and a lot of distribution has accompanied the rise.

It is also of interest that at no time on the recent advance was the Dow able to better its 200-day moving average (the MA now stands at 3289 and is now declining).

PTI: Now I'll talk a bit about my PTI. The PTI has one function -- it's to define the current underlying trend of the market. The yield on the Dow can drop to 1%, the market can be grossly overvalued and highly dangerous, the consensus opinion can be overwhelmingly bullish or bearish, but if the PTI continues to climb -- watch out, the market is going higher.

As you can see on the Page 2 chart, the PTI has been marching to new highs. I call the PTI my "fail-safe" indicator. Rule: you never bet against the PTI. You may not believe it, you may not like what it's saying, but you don't position yourself against it.

When the PTI is climbing, as it has been, you either invest with the PTI or you stand aside. But you don't dare fight the PTI, which means that you don't short stocks and you don't buy puts (ironically, there are a record number of shorts now on the NYSE).

The PTI is a cold, emotionless index. It pays no attention to anything but areas of market action. It's based on the cumulative action of eight critical "action-of-the-market items," and when the majority of these indicators trend up or down, it's literally impossible for the market to go against them for any length of time. 'Nuff said about the PTI.

DOW THEORY & VALUES: It's strange, almost everyone in the investment business has heard of Dow Theory, but not one in 1,000 has really studied the Theory or read anything that Charles H. Dow actually wrote. It may surprise you to know that most of what Dow wrote had to do with values. "To know values," wrote Dow, "is to know the meaning of the market." Dow never really emphasized using the Averages as a predictive device. Dow invented his Dow Jones Averages to demonstrate one of his basic tenets, namely, that the market doesn't wander aimlessly about, but that it is subject to definite trends -- major, secondary and minor trends.

Despite all that Dow wrote, analysts today, when they talk about Dow Theory, confine their analyses and comments to the action of the Averages. The crucial question of values is seldom discussed.

George Schaefer, writing his famous *"Dow Theory Trader"* during 1948 to 1974, was the Dow Theorist who went back to basics and true Dow Theory. On June 18, 1949, Schaefer wrote what I consider to be one of the greatest and most prescient stock market reports ever penned. The report was written exactly five days after the start of one of the most fabulous bull markets in American history.

In his June 18, 1949, report Schaefer turned rampantly bullish, predicting that a great bull market was about to begin. The report stressed VALUES. Wrote Schaefer, *"In the past 17 years only three opportunities have presented themselves to buy stocks at great values, and now the fourth opportunity is making its appearance. I continue to regard stocks as having entered a 'buying period' on the basis of values. Good dividend-paying stocks should be purchased during periods of market weakness and held until such times as yields for the D-J Industrial Average are back in the 3% to 3.5% area. Once stocks are purchased, both the minor and secondary movements should be completely disregarded. A new period of prosperity will follow, once the present recession has run its full course."* That was the picture in mid-1949. But times have changed.

That was 1949, this is 1992. The stock market is now at the other end of the spectrum. Values are extremely thin, and the public does not have to be told to buy stocks, they are buying stocks willy-nilly. Billions of dollars are pouring into Wall Street, and neophyte investors are combing the secondary and tertiary issues for the next winner.

What about values? Are there tests for values? The answer is yes, there are definite tests. I will present a few as follows.

The first is based on the November 23 article in *Barron's* by John Harder. This article discusses the bond/stock ratio. This measurement is based on the ratio of *Barron's* high-grade bonds divided by the earnings yield on *Barron's* 50-stock Average. The earnings yield is simply the number 1 divided by the earnings (it's figured the same way as the dividends yield except that earnings are used instead of dividends).

Actually, you don't even have to compute the bond/stock ratio, it's listed in each issue of *Barron's* under the *"Barron's* 50-Stock Average" box. The current bond/stock ratio is 1.87. Translated, this means that the best-grade bonds are generating 1.87 times the return obtainable for the 50-stock Average. For comparisons, on the week of August 25, 1987, just before the crash, the bond/stock ratio was 1.63, actually lower than it is now.

Personally, instead of comparing the Best-Grade Bond yield with earnings yield on the 50-Stock Average, I prefer comparing the Bond yield with the actual yield on the Dow. Currently, the High-Grade Bonds yield 8.21% while the Dow yields 3.19%. Thus the bonds provide a yield or return which is 2.57 times the yield on the Dow.

Here's another significant comparison: the broad S&P Industrial Index now yields 2.92. At a yield of 8.21%, the high-grade bonds yield 2.81 times the yield on the S&P Industrials. To my mind, these two examples are telling us that stocks are flagrantly overvalued.

And this is yet another way of gauging values. The yield on the S&P 500 Stock Index is now 2.95%. We divide 1 by 2.95. This shows us that it costs 33.8 dollars to buy one dollar of S&P dividends. The time-honored danger signal arrives when it costs anything over 30 dollars to buy one dollar of S&P dividends. We are well over that figure now.

I am including on page 3 a chart of the S&P 500 and its dividend yield going back to the late-1920s. The chart is well worth studying [chart courtesy of *Ned Davis Research,* (800) 241-0621].

Individual Investor Trim Tabs (PO Box 2949, Santa Rosa, CA 95405) has given me permission to reprint this very insightful piece. They label it, "Stock Market Still Priced Higher Than in 1929 and 1979."

Patrick Dolan, Senior Manager of KPMG Peat Marwick's Valuation and Appraisal Group, has recently updated his valuation model for the S&P 400. Previous results of his model were last summarized here on March 30, 1992.

Mr. Dolan's model does not use actual earnings nor dividends. Therefore, write-off depressed earnings do not artificially inflate PEs and dividend payout ratios. Rather, the model currently starts with averaging 1991 and 1992 book values for all the 400 issues in the S&P Industrials index. That comes to about $160. Since 1926, the average profitability on book value has been 12.01%. Multiplying 12% times $160 equals pro-forma earnings of $19.20 per share. This earnings number is then capitalized by the average price earnings ratio over the past 66 years of 13.5. That would mean that a normal value for the S&P 400 with $160 in book should be 259.

Dolan's second component applies the average price/book value of 1.593 to the estimated 1992 average book value per share of $160. This results in a formula price of 254. The third component is derived by dividing the $19 per share in pro-forma earnings by the historical average dividend pay-out ratio of 57.5%. That results in a proforma dividend of $11 per share. Capitalizing the $11 dividend by the average dividend yield of 4.36% results in a proforma price of 253.

Averaging the three formulas equals 255. That compares with the current S&P 400 price of 493 and makes for a ratio of the two of 1.93. Mr. Dolan has looked at other major market tops and found that the ratio back in 1929 was at 1.91 and in August 1987 at 1.90. The all time high of 1.99 was reached on January 15, 1992 when the S&P 400 reached a peak of 499 — not far from current prices.

We have long been saying that the only reason this market keeps staying up here is the inflow of sucker, er individual, money coming out of CDs. When that inflow ends, so will this all-time historically overvalued market.

Finally, I refer to the percentage of undervalued blue-chip stocks as listed on top of the front page in each Letter. The percentage of undervalued stocks is now a thin 10%. Earlier this year the percentage was at a record low of 8%. We are now in the area where every bear market has started. Bull markets, on the other hand, start when 80% or more of the blue-chip stocks are undervalued.

Obviously, none of the value tests will pinpoint when a bull market is starting or when a bear market is about to begin. Stocks, as you well know, can stay in the undervalued or overvalued zone for long periods of time. But values do tell you where you are in the big picture. And in the big picture, stocks today are extremely overvalued. So at this time it would be well to remember the words of Charles H. Dow, "To know values is to know the meaning of the market."

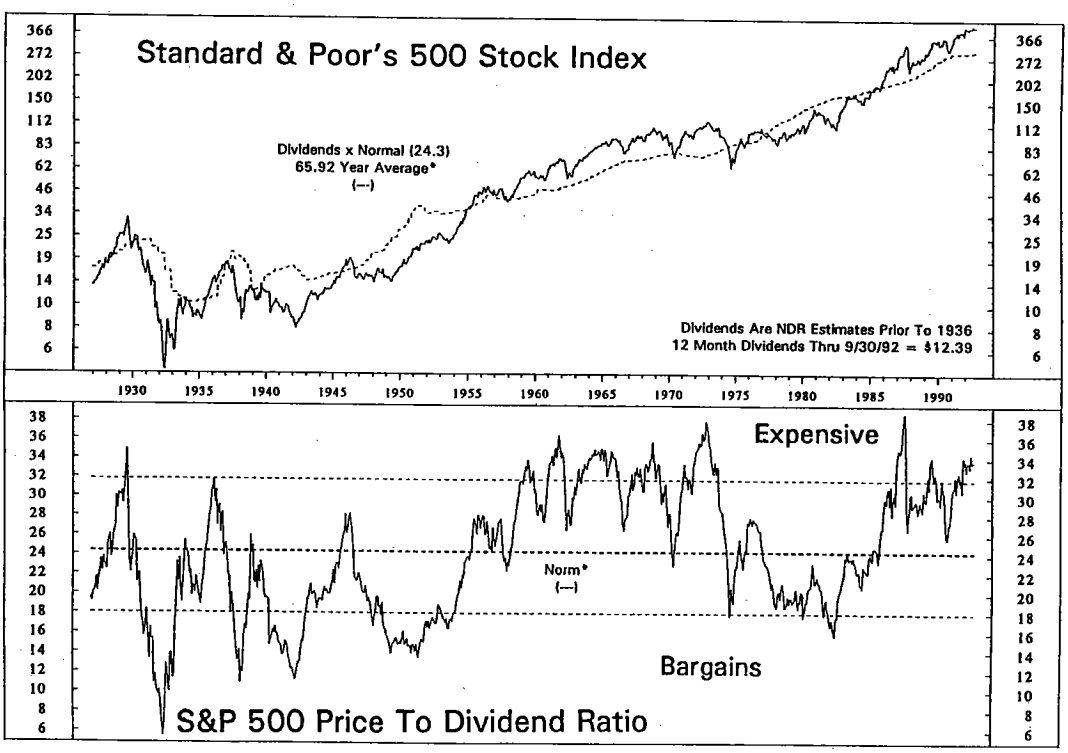
INVESTMENT POSITION: With the PTI going to new highs along with the NYSE Composite and the S&P 500 I have questioned myself on the correctness of my bear market stance. I don't want to be stupid or stubborn, but the fact is that the Dow did break down in October, thereby confirming the earlier breakdown of the Transports. Furthermore, the Dow has not even bettered its earlier September peak, much less its all-time high of 3413.21.

SO-O-O-0-0, I'm going to stick to my bear market designation, and I won't change it unless the Dow breaks out above previous highs. After all, the Dow Theory is based on the action of the D-J Averages, and that action has not been impressive. Then, there's that little matter of super-overvaluation.

I've been getting (believe it or not) calls from other investment advisors asking me what I'm doing with my own money, and do I have any suggestions regarding their own accounts (ah well, when that happens you know it ain't easy).

My suggestions run something like this -- 5% in Hong Kong stocks, 5-10% in assorted gold items, 10-15% in US stocks (US stocks that you can't resist), maybe 50% in short US money (muni money market funds, T-bills, one year T-notes, etc.), and around 20% in German government bonds.

Basically, I think this is <u>waiting time.</u> There are very few blue-chip bargains in stocks, I think the market is dangerous, values are shouting danger, and it's probably a good time to take a vacation. But don't get me started on vacations, I haven't taken as much as a 10-day vacation since I started this business 33 years ago. Every business has its drawbacks, and that's the drawback in my business -- when you're out of town, you're out of touch.



DOLLAR, CURRENCIES: Three months ago everyone and his brother was bearish on the dollar. So what happened? The dollar bottomed out in early September at a fraction under 80 on the December Dollar Index. Then, as the dollar (surprise) rallied, everyone turned bullish on the dollar, with predictions of the Dollar Index going to 100, 110, even higher.

Traders shorted the D-mark (Europe's key currency) and the Swiss Franc, and newspapers explained that German interest rates had nowhere to go but down while the consensus was that US interest rates had bottomed and were heading up. Soon, promised the experts, the two nations' rates would cross. Furthermore, it was reasoned, the US economy was coming out of recession while Germany and Europe was moving into recession. The clear, obvious conclusion -- the dollar was

heading higher while the mark was doomed to sink into the cellar.

But around mid-October a funny thing happened. Although the D-mark was still sliding, momentum on the mark turned up. Then in early November (despite all the dire predictions) the mark stopped going down. From a low of .6150 (Dec. contract) the mark has been edging up. As this Letter is written, it is in the high .6300 area. At .6400 on the Dec. contract the mark breaks out to the upside. My opinion: Look for a trading range in both the D-mark and the dollar, but a wide trading range.

In the meantime, longer term the yen has been strong against the dollar. Short term, the yen has been surprisingly resistant to rise. At .815 on the Dec. contract, the yen would break out of what looks like a base -- and head higher.

NOTES & QUOTES: Hey, how are we doing? Oh, you're talking about the federal deficit? Well, honestly, not too great. In October (the beginning of the new fiscal year) the government spent nearly two-thirds more than it took in. Spending rose to $125.7 billion against $114.7 billion in October of '91. Revenues were $76.8 billion down from $78.8 billion in October '91. So we had an October '92 deficit of $48 billion. Interest on the federal debt in October was $18 billion, and interest was projected to be $307.5 billion for the entire year (that's bigger than the huge military budget which will be $278 billion this year).

And gosh, entitlements were kinda big. Social Security payments amounted to $22.8 billion for the month while Medicare and Medicaid amounted to around $25 billion. Social Security and the health items together will add up to $588 billion this year. Pretty soon you're talking about real money.

Mr. Clinton is becoming very quiet about cutting back on the growth of the deficit (nobody's talking about actually reducing the deficit). Clinton's advisors are telling him that before any deficit cutting we've got to jazz up the economy. And how about that tax cut for the middle class? Mmmm, well Clinton never asked us to read his lips.

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After knocking off (i.e., forcing devaluations) many European currencies, the FOREX (foreign exchange) traders are now rumored to be looking at the French franc. Up to now, Germany has come to the rescue of the franc when it has been attacked, which means that the Bundesbank has been buying francs in order to support it. But to buy a currency the Bundesbank has to issue (create) additional Deutschemarks, and this means an increase in the German money supply. In October the German M-3 money supply increased by a very unacceptable 10.2%. Therefore, there is a question of whether Germany would want to continue supporting the franc if it is attacked again by speculators. If the French franc does fall, and if France devalues or drops out of the European Exchange Rate System, we can consider the ERM dead, unsustainable because of the differences in the various European economies.

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Canada's giant Olympia & York, which was the world's largest developer before it filed for court protection last May, stated that failure to approve their debt-structuring plan will probably lead to the company's bankruptcy and forced liquidation of its assets. Thirty-four groups of creditors will vote on the plan around the end of November. O & Y's total debt is over 10 billion in US dollars.

* *

This may be one of the most important items of the year. Zhu Rongji is China's economic czar, and he is the West's best hope for a "better China." A few weeks ago Zhu, in recognition of his key role in engineering China's economic boom, was elevated to the all-powerful politburo. The English-speaking vice-premier is considered the most liberal of China's leaders. Zhu has been put on the Hong Kong case, which is a question of whether China will allow more Democracy in Hong Kong. The feeling is that Zhu may make a deal. Said Britain's Prime Minister John Major, "Zhu is one of the good guys. He may be on our side." Russell comment: Let's hope Major is right. Zhu is now positioned to go for the power when Deng Xiaoping dies.

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The European Exchange Rate Mechanism (ERM) seems to be dividing Europe into two sectors. One is the hard currencies, the currencies of Germany, France, Holland, Belgium, Luxembourg, and maybe Denmark. The other tier consists of Spain, Portugal, Britain, Ireland, Italy. Most of the second tier have already been devalued against the German mark. Sweden has dropped out of the ERM as has Britain, Italy and Switzerland.

The ERM lasted for five years, but this year with European economies sinking into recession the weaker nations with weaker currencies couldn't hold their currencies together. Speculators saw the weakness and attacked (sold off) the weak currencies, forcing these nations to devalue and in some cases drop out of the ERM system.

This was to be the decade of Europe, the ascent of the continent. Instead, it is the year of chaos for Europe. But the really remarkable thing is that the US has, so far, been so unaffected by the rest of the world's problems (including, of course, Japan's problems).

What has insulated the US and its markets? Russell opinion: the US Government's willingness to take on huge amounts of debt to forestall a potential depression and turn it into the "contained depression." Question: Can it be that easy and painless to contain a potential depression? Answer: No, it isn't. Somebody's got to take the pain. And so far it looks as though it will be our kids. They'll inherit the trillions in debt, and they'll see their purchasing power decline -- either through inflation or deflation. Today's "contained depression" should be called "the transferred depression." Transferred to the future -- probably in the form of fierce inflation somewhere ahead.

* *

I must admit that I'm seldom shocked by stories that appear in the newspapers. But the story on the US losing its share of world trade in grains and soybeans (*WSJ* Dec. 3) shocked me. I knew that the US had always been number one in agricultural production and exports, but now we're losing out. Over the last decade the US dropped 24% in grain exports while our soybean exports dropped 12%. Agricultural exports have always contributed heavily to our balance-of-trade. The current trend in Agr. exports will be a major negative.

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Ah, poor California. As the state moves into its seventh successive drought year, more "water news" emerges. A great deal of research has been done on tree rings. The rings on ancient trees show what happened weather-wise during past centuries. Lisa Graumlich has examined ring patterns of Foxtail Pines and Western Junipers and compiled a detailed record of year-to-year variations in temperature and precipitation over the last thousand years. Her research shows that the 20th century has seen more exaggerated swings in moisture than any other period of the last thousand years. She is particularly concerned because the tree rings clearly show that the years 1937 to 1986 in the Western US have been abnormally wet compared with previous centuries, and these were the years of the greatest immigration to the "golden coastal states." If the rain patterns revert to what has been normal for the last thousand years, California (and particularly the agriculturally rich Central Valley) are due to suffer unbelievable drought problems.

As if that's not enough, now a group of California's leading scientists tell us that there's a 47% chance that California will suffer a mighty "7 on the Richter scale" earthquake within the next five years.

* *

High fashion, haute couture, and super-luxury are having a hard time. The new "in" thing with the kids and many fashion houses is grunge (better known as sleaze). I can see it in my own kids. Messy T-shirts, pants slipping below the hips, open sneakers, the "I'm broke" look. Even in jewelry it's not diamonds or rubies, it's semi-precious stones (tourmaline, opals) and lots of 18-karat gold that are being seen. Headlines the *London Financial Times*,

"Luxury -- A Dated Concept in the '90s. Meretricious displays of wealth are completely passe now."

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Are you wondering why the pages of your favorite magazine are stuffed with perfume ads and exotic odors? Reason: that's where the money is. Almost all of the top fashion houses are now pushing perfume and in many cases perfume constitutes by far the greatest percentage of their profits (in some cases, 80% of profits are from perfumes). There are now, worldwide, over 1,000 perfumes being offered.

* *

Charles Biderman of *Market Trim Tabs* [(707) 538 1290] tells us where the money is coming from and where it's going. He reports that "investors have been flooding aggressive growth funds with huge inflows." In the week ending Nov. 18 investors shoveled new money into equity funds at a monthly rate of $7 billion vs. $5 billion at the end of October. These are enormous sums, and the resultant buying has reached the frenzy stage.

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Want to make millions as a screen writer? Here's how it's done. Joe Eszterhas received $3 billion for the fantastically successful "Basic Instinct" (it grossed over a third of a billion dollars around the world). Then recently he received $2 million to do a movie called "Jade." Now Eszterhas has a new project called "Showgirls" for which he got $2 million in advance, and he will receive additional millions if a studio puts it into production. Said his agent, this is "a unique mind-boggling deal. I've never seen anything close to this in my time." Said Eszterhas about "Showgirls," which will be about three showgirls, "It will be raucous, joyous and powerful. It's about rock 'n roll, the flesh, dollars and dreams. It begins in the world of erotic dancers, lap dancers, table dancers, strippers and sleaze. It moves into the world of big hotel showgirls, billboards and glamour. It examines the sleaze and glamorous and asks the audience at the end to make its own moral conclusions." Russell comment: Does this guy know what sells or what!"

* *

Did you hear about the Nada bird. It builds a nest with a hole at the bottom? Why? It loves laying eggs, but it can't stand kids . . . And then there's the exotic new bird discovered in New York's garment center -- it's the Double-Breasted Seersucker.

* *

The new political jokes are starting. Al and Tipper Gore were taking a walk in the woods when they were suddenly confronted by a frothing Grizzly bear. Al began a speech, and the Grizzly promptly fell asleep. . . Howard Ruff tells us that at the Clinton's inauguration in January, the Marine Band will strike it up with "Inhale to the Chief." Finally there's trading faces -- it looks like we've traded a president who can't talk for a president who can't stop talking.

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Did you ever think of checking on whether your bank has figured your mortgage payments correctly? According to *Worth* magazine (Dec/Jan), "Estimates of the number of residential mortgages that are being miscalculated range anywhere from 20% to 50%. As many as 70% appear to benefit the lenders, which means that homeowners collectively could be overpaying by as much as $7 billion a year."

* *

Call me big daddy, call me greedy, call me worried, but I'd like all my subscribers to live to be 100. One way that will help is to take vitamins (in fact, in view of the evidence it's stupid not to). The following is from the latest *Vogue*: In a ten-year UCLA study, it was found that those who took 300-500 mg. of vitamin C had a 24-45% lower death rate from heart disease and a 10-42% reduced death rate from all diseases . . . In another study of 87,000 nurses, those who consumed 15-20 mg. of beta-carotene had 40% fewer strokes and a 22% reduction in heart attacks compared with those who took less than 6 mg. a day. Finally, vitamin E in doses of over 100 mg. was associated with a 36% lower risk of heart attack when compared with those taking less than 30 mg. a day. Note: It is now thought that plaque build-up in the arteries can be resisted by taking anti-oxidants. Vitamin A, C and E are all considered anti-oxidants.

* *

My old friend Harry Browne is not optimistic about "change" in the Clinton Administration. In his latest report, Harry writes, "Let's start with Bill Clinton's campaign theme that he would bring *change* to America. The one thing we can be sure of is that there will be no change in direction -- no new approaches to dealing with *any* problem. Clinton will continue -- and expand -- George's policy of using government to 'solve' every conceivable social problem -- taxing more, spending more and regulating more. Bush called Clinton's policies 'tax and spend,' and who should know better than Mr. Bush -- the biggest taxer, spender and regulator of all time." (*Harry Browne Reports,* PO Box 5586, Austin, TX 78763).

* *

During the 1980s, all the nations of the world taken together privatized 8,000 companies. Russia, within a year, hopes to privatize over 6,000 companies. "Don't laugh yet," says the London *Economist,* they're setting the mechanism to do it, and it could happen.

* *

All over the world people are dying from infections that no longer respond to the 160 various antibiotics that are now on the market. Ironically, most of the new infections occur to patients in hospitals. Many drug and biotech companies have joined in the fight against these drug-resistant bacteria. SmithKline Beecham has taken the lead in this area.

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The US Congress is the world's most expensive. In 1970 they cost Americans $343 million, today they cost us $2.8 billion. In the last 30 years their salaries have exploded from $22,500 to $129,500. During the same period their staffs have quadrupled to a current 20,000. In the meantime, Congress has excluded itself from 16 major laws (which we citizens have to obey) including Social Security and the Civil Rights Act. We elected them, we keep re-electing them, we deserve what we get.

* *

If you're a sports fan in San Diego, you've got to be excited. No pro football team in history has ever lost its first four games and then made the playoffs. San Diego lost its first four games, and has now won eight out of its last nine games, and the team has a slim (but still alive) chance of making the playoffs. Go Chargers!

GOLD: Almost every nation in the world is now running a deficit. Of course, some countries like Japan and Germany have high savings rates, so they can more easily finance their deficits. That, unfortunately, is not true of the US.

Deficits ordinarily are deflationary -- unless they are monetized or underwritten by massive creations of new money, in which case deficits become inflationary.

I don't think this country under Clinton or anyone else is going to reduce the US deficits [reduce them (?), we're not even being honest about how big they are]. So as I see it, all the deficits we're currently producing (at the rate of a billion dollars a day) will ultimately be handled in only one way -- through inflation. You can see the picture clearly in the action of the Fed over the past few years. The Fed is terrified of recession and deflation, and they've fought it tooth and nail -- with a manipulated collapse in interest rates and with a massive explosion of M-1 and adjusted reserves.

When it comes to inflation vs. deflation, this country will not tolerate deflation. They'll attempt in every way to inflate it away. Furthermore, consciously or unconsciously, Washington knows that with a total of $15 trillion in debt outstanding, the economy can't hold together in the face of deflation. The deflationary power of massive debt must be "neutralized" via inflation and a debasement of the currency.

This item appeared a few weeks ago, and I found it most interesting. Why in the world would nations line up to sell Eurodollar bonds? Only one reason -- they think they'll be able to pay off their bonds with cheaper dollars. The Treasurers of these various nations are not stupid, they know the history of the US and the history of the dollar. Why sell bonds in a hard currency with an anti-inflationary history when you can sell your bonds in a currency that has an unending history of debasement. And the

ultimate sweetener is that you're selling your bonds in Eurodollars, which have a low coupon cost. America the beautiful, America the bargain.

Countries Are Lining Up To Sell Dollar Eurobonds

By Mark Gilbert
Bloomberg Business News

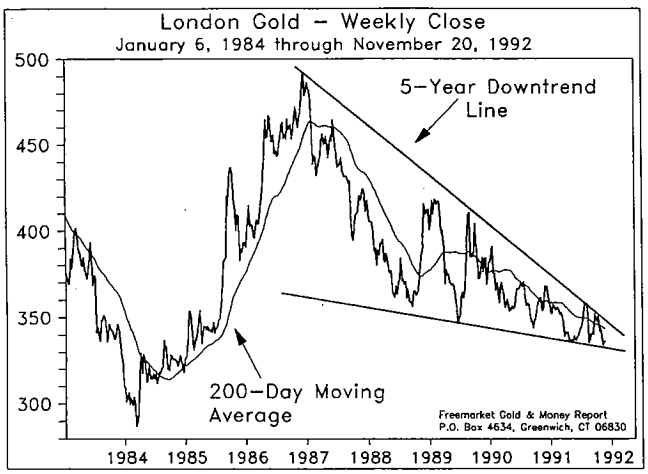
LONDON — At least four sovereign borrowers are lining up to sell new dollar-denominated issues in the Eurobond market, bankers said. This flood of new sovereign debt could make some of the issues difficult to sell, they said. Finland is to start things off Monday with at least $1 billion of global bonds, underwritten by Merrill Lynch, J.P. Morgan and Nomura International.

"People are viewing U.S. bonds as a good buying opportunity, though a lot of accounts are slow to make up their minds," said an official at Merrill Lynch in London involved in the Finland issue.

U.S. government bond yields have risen after Bill Clinton's victory in the U.S. presidential

Gold must be noting what's happening. From it's very brief breaking of 330, gold has been creeping tortuously higher. An upside breakout would occur at spot 340. At 345 gold would reverse its most recent bearish trendline.

This massive declining wedge pattern in gold has been forming ever since 1987. Declining wedges usually denote a slow drying up of supply. The last peak (arrow) comes in at 355 on gold. It would take a rise above 355 to move gold above the 5-year downtrend line described on this chart (chart courtesy of *Gold & Money Report*, PO Box 4634, Greenwich, CT 06830).



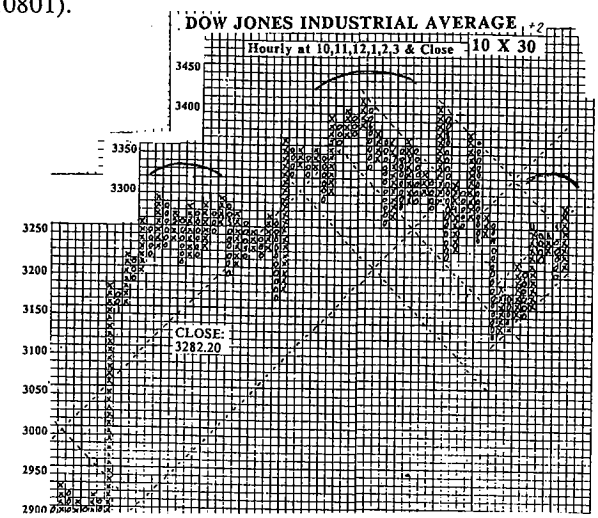
But remember this. The public doesn't understand or worry when the dollar hits a new low against the D-mark. But let gold rise over 350, and the public knows what that means. The Fed knows too. Are our "leaders" manipulating the gold market? That's the rumor, and frankly, it wouldn't shock me if it were true.

It's interesting: followers of the "long wave" say that we're in the early stages of a massive, relentless global deflation. Those who watch the Fed's action say that the Fed has, and is, generating guaranteed future inflation. I say watch gold -- gold will tell the story.

LATE NOTES & THOUGHTS: The near-term trend is UP but getting tired. Day after day the differentials between advances and declines is slight, and this is occurring on high volume. What does it mean? As a rule, it implies "churning" comparable to a person running up the down escalator.

With many of the composite averages at record highs, daily new highs in stocks have been decidedly sub-par, and this again is a sign of an ageing advance.

Finally (and I've mentioned this before), the Dow itself has formed what looks suspiciously like a massive head-and-shoulders top. This point & figure chart shows the pattern very clearly. It's as if the secondary and run-of-the-mill stocks are carrying the market while the big blue-chip issues are being distributed -- hardly a healthy sign (P&F chart courtesy of *Chartcraft*, New Rochelle, NY 10801).



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Increasingly, Wall Street's eyes are fixed on the economy and less and less on the Fed and the money numbers. The Fed itself is obviously wondering what's going on. The M-2 statistics don't seem to be reflecting the improving economy, and Greenspan himself (maybe worrying about the explosion in adjusted reserves) came out and suggested that maybe the Fed's M-2 target was too high (the fact is that a lot of today's money is pouring into stocks and bonds rather than into the economy itself, and this is messing up the statistics while not being reflected in the money supply figures).

It appears that the Fed has done all it's going to do, and now the big question is -- what is Clinton going to do, or more realistically, what is Clinton going to try to do. The reason I say "try" is that Clinton's wishes may not sail through Congress as easily as everyone would have you believe. For instance, there are already a lot of doubts about Clinton's "tax cuts for the middle class" as well as his upping the taxes on the rich. Many analysts are wondering how Clinton can cut taxes at all and at the same time halve the federal deficit within four years (which is what he promised). Furthermore, Clinton's "savings" from spending cuts have been criticized as pipe dreams. Or if Clinton can actually engineer some savings, the sophisticated opinion is that they will be a drop in the deficit-bucket.

Older subscribers are well aware of the Russell opinion. If I had my way, the whole US tax system would be junked, completely jettisoned and labeled as a political boondoggle. Why in the world should people and companies have to spend hours, even days, figuring out their taxes and figuring new ways to avoid taxes. It's ridiculous. A single flat tax would serve better and save literally hundreds of millions of man hours that could be used in constructive ways.

Furthermore, as far as reducing government spending, I firmly believe (and I will write more on this in a future Letter) that the spending machine of the US government has taken on a life of its own. It's like a giant cancer, and it cannot and will not be halted short of national bankruptcy. The spending, or should I say over-spending, can be seen by following the path of the national debt. In 1980 the national debt was equal to 26.8% of the nation's economic output. By 1988 it constituted 42.6% of the nation's output. This year the national debt will go over the 50% level -- it will be equal to 52.5% of the nation's output. You can imagine what would happen if this country ever goes into a severe recession in which the nation's output drops say 15% or 20%. (During the 1930s the nation's output dropped 50%, so you can see why the US cannot, absolutely cannot take a real recessionary deflation.)

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